

APPENDIX

NOTES FOR FOMC MEETING
August 18, 1987

Sam Y. Cross

For the past three months, dollar exchange rates have drifted gradually upward and now average about 6 percent higher against the G-10 currencies than at the dollar's low point in early May. Since your last meeting in July, the dollar has risen on balance by about 1 percent, and at various times it has experienced both buying and selling pressures. Recently there has been a general feeling that a better sense of two-way risk has returned to the market. But looking farther ahead there is still much skepticism about the future course of the currency in light of our slow progress in reducing the trade deficit. With respect to our operations, during the first week of August, when there were strong upward pressures on the dollar, the Desk entered the market on behalf of the U.S. authorities, selling dollars against marks in coordination with other G-7 central banks.

A factor underlying the dollar's rise this summer has been the improving outlook for economic growth in the United States. The prospects for U.S. expansion strengthened following release of several economic statistics, including the second quarter GNP and the employment data. This improvement in our growth prospects contrasted with growing disappointment about the outlook for the German economy.

Another factor contributing to the dollar's rise was the flare-up of tensions in the Middle East, where disputes about

shipping and riots in Mecca precipitated a significant marking up of dollar rates in the exchange market. With these pressures the dollar moved above levels at which the market had previously expected that the central banks might intervene to try to stop the dollar's rise. Once market participants realized that there might not be an effective cap placed on the dollar, they tended to move from short dollar positions to long, and also to purchase dollar call options.

The upward pressure on the dollar focused on the mark and not the yen. As compared with Germany, Japanese growth prospects seemed to be improving and there were reports that Japanese financial institutions were repatriating capital in response to rising long-term interest rates and higher loan demand at home. Moreover, there appears to be much more concern about the impact of trade on the relationship of the dollar to the yen than to the mark. Also, there are reports that Japan's oil inventories are relatively high, whereas Germany's are said to be low, so that Japan could better withstand a temporary disruption of oil supply.

On August 4 when the dollar was rising and bidding for the dollar/mark exchange rate became intense, the U.S. authorities sold dollars on the exchange market, and the Desk sold dollars again on August 6, 7 and 10. All of the operations were aimed at showing the market that the authorities would provide resistance to upward pressures on the dollar when these pressures became significant, without trying to place a ceiling on the exchange rate. Therefore, we sold dollars only when the dollar was moving up rather strongly. Though all of the dollars were sold in a

range around DM 1.88 to DM 1.90, the operations were in different amounts and at different levels. The market appeared to have understood what we were trying to do and did not feel that we were trying to drive the dollar down. Intervention was thus seen as a factor contributing to restraint in the movements of dollar exchange rates. In total we sold \$631 million against marks on those four days. At various times we were joined by the Bundesbank, the Bank of England, the Bank of France and the Bank of Canada.

The operations of the Desk were performed in this manner in an attempt to preserve a sense of upside risk. Particularly at a time when market participants remain skeptical about our ability to deal effectively with our large trade deficit, we want market participants to feel there is a risk that the dollar might go up in the short run. Otherwise, the market could quickly revert back to a one-way street -- with the dollar in the downward direction -- just as we saw last spring. The events of last Friday, after our disappointing trade deficit for June was announced, illustrated how quickly market psychology can change. The dollar moved down two to three pfennigs in a matter of minutes. When the market again found its balance, the dollar was still trading at high enough levels to persuade market operators that a new dollar downtrend had not necessarily been put in place. However, today we have had a second wave of dollar selling, apparently still in response to the trade numbers, and the dollar is now about 3-1/2 percent below last week's levels, both in terms of marks and yen.

As you know, the System's holdings of yen had become quite

depleted as a result of our intervention operations of this spring. We therefore decided to take advantage of opportunities presented to us by our customers to purchase modest amounts of yen for the System. The first such operation took place last week when we purchased a little more than \$36 million equivalent of yen to replenish our balances.

Notes for FOMC Meeting

August 18, 1987

Peter D. Sternlight

The domestic Trading Desk has continued to aim for essentially unchanged conditions of reserve availability in the period since the last meeting. New information during the period gave a mixed picture. M2 and M3 in July grew at only 2-3/4 and 2 percent annual rates, respectively, compared to the 5 and 7-1/2 percent rates for June to September adopted at the time of the last meeting. At the same time, there were signs of strength in the exchange value of the dollar, sufficient to prompt some coordinated intervention to blunt its rise. Meantime, though, economic data tended to show a bit more strength than expected, and inflationary concerns were evident both in U.S. and foreign markets, punctuated at times by higher prices for oil and other commodities.

In weighing these developments, the Desk initially aimed for unchanged conditions. Toward late July, while holding the path level of borrowing unchanged at \$500 million, the Desk sought to manage reserves with a bias such that deviations in borrowings would more likely be a bit under than over the path level. Most recently, the Desk has returned to a more balanced stance as further data continued to suggest reasonable strength in economic activity and as early readings on August money growth suggest a pickup.

Compared to the previous period, the Federal funds market tended to have a more comfortable tone, with rates typically toward the lower part of a 6-1/2 to 6-3/4 percent range. (In much of the previous period, with the same path borrowing level, funds had been around the high end of that range.) One exception in the recent period was in the closing days of July and early August when the Treasury auctioned and settled a huge volume of securities in a compressed schedule, creating large financing needs and putting upward pressure on the funds rate. Higher funds rates emerged again in the last couple of days with the approach and arrival of settlement date for the Treasury's mid-quarter financing.

Debt ceiling developments weighed both on the Desk and the markets during the period. Expiration of two temporary debt ceilings and last gasp extensions complicated reserve management and disrupted normal Treasury auction patterns. For the first time, the System had to allow its entire holding of a maturing bill issue to run off at maturity because the Treasury was unable to issue any immediate replacement. Often in the past, it has come down to the last minute, but exchange arrangements were possible. However, this time, no Congressional action had been taken by July 23 when 3- and 6-month bills matured, and the Desk had to redeem nearly \$4 billion of maturing bills. Earlier, a \$600 million bill redemption was undertaken deliberately to drain redundant reserves.

The \$4 billion bill paydown took place midway through the July 29 maintenance period--when there was, fortunately, a need to drain reserves. The paydown turned a large estimated need to drain reserves into a modest need to add. The following period required further reserve additions as the full effect of the paydown was felt. Nonetheless, reserve operations other than the bill paydown were generally modest. The Desk sold securities to foreign accounts early in the intermeeting period when there was a need to drain reserves and arranged a couple of matched sale-purchase operations in the market. After the paydown, it purchased bills from foreign accounts and arranged a series of RPs, mainly for customer account. Net over the full period, outright holdings were reduced by about \$4.35 billion. While the debt ceiling forced the timing of the reduction in the System's portfolio, the period was one that called for draining reserves, chiefly to offset the impact of declining Treasury balances at the Fed. Even absent the debt ceiling complications, a substantial portfolio reduction was in order--though probably not as great as actually occurred, and with different timing.

Despite all the distractions, borrowing turned out close to the \$500 million path allowance, falling a bit short in the first and third maintenance periods and exceeding it slightly in the middle period. For the three maintenance periods completed during the intermeeting interval, borrowing averaged about \$465 million. Nonborrowed reserves alternately fell short of and exceeded the nominal objectives as excess reserves swung

widely during the period. The bulk of the swings in excess were predictable, reflecting a sawtooth pattern to reserve carry-ins at the large banks. The Desk made informal allowances for them, alternately aiming to come in short of the formal nonborrowed reserve path and to exceed it. Actual swings were similar to but a bit wider than the estimates.

Most intermediate and long-term interest rates rose over the intermeeting period, with the increases concentrated in the latter half of the period. However, a sharp rally occurred last Thursday after the 30-year bond auction, and the market has maintained these gains despite a brief retreat when a larger than expected June trade deficit was announced last Friday. Yields on longer term issues topped their May peaks in early August but have since receded somewhat to show a net rise for the 30-year Treasury issue of about 40 basis points. That places the long bond around 8.80 percent, after having pushed briefly a little over 9 percent in early August.

The rate increases appeared to reflect a general global disenchantment with fixed-income securities in the face of concerns about higher inflation down the road, and an increasing focus on equity markets. In some major foreign markets, notably Japan, the rate rises were sharper than in the U.S. Japanese long-term rates have risen about 100 basis points since early July, in part due to oil-based inflation fears. The Japanese market was also unsettled by an unexpected issue of two-year notes. Sterling yields were up about 80 basis points, largely

reflecting a full percentage point rise in the Bank of England's intervention rate on August 6. In Germany, long-term rates rose about 50 basis points.

In the U.S., inflation concerns were heightened by increases in oil and precious metal prices at the time tensions in the Persian Gulf heated up, and new economic data suggested a stronger outlook for the third quarter than was anticipated earlier. Chairman Volcker's Humphrey-Hawkins testimony, indicating no recent change in policy where some observers had sensed a partial reversal of the April-May "snugging" move, also provided some upward push.

The debt ceiling delays also affected trading over the period. Yields backed up once the ceiling expired on July 17 and participants became increasingly concerned about the bunching of the auctions once a new ceiling was passed. The compression of five auctions totaling about \$60 billion of bills and notes within 4 business days following the first extension of the debt ceiling appeared to cause somewhat higher auction rates than would otherwise have prevailed.

One week after these auctions, the Treasury began its \$28 billion refunding auctions--a week behind schedule. The pre-auction dealer talk was that yields would have to back up to attract investor demand in view of the general market malaise, the sharp narrowing of spreads between U.S. and Japanese bonds since the last refunding, and the shortened period between the auctions and settlement date for the new issues. As it worked

out, once rates had backed up, there was good bidding interest in all three auctions and each issue traded up in price following its sale. The strength of the 30-year auction was especially notable, with the ratio of bids to awards the highest in three years.

The Treasury paid down only \$1/2 billion in bills over the period, and raised \$18-1/2 billion of new cash from sales of coupon issues. After the run-up in late July, bill rates have leveled off or even declined slightly in the last two weeks. In yesterday's auction the 3- and 6-month issues were sold at 5.97 and 6.12 percent. These were up from the 5.62 and 5.68 percent rates just before the last meeting. Elsewhere in the short-term market, among private instruments, rates showed little change over the period. The rise for Treasury bills seemed to be the result of an abatement of special factors that had pulled those rates down earlier--notably the stream of bill paydowns and the prospect of even greater supply interruptions because of the debt ceiling. The passage of a new temporary ceiling, and subsequent bunching of auctions, suddenly relieved the earlier technical shortage.

Currently, bond market sentiment seems to remain on the wary side. As noted, the anticipations of a System "de-snugging" failed to find confirmation in the July Humphrey-Hawkins testimony, and market participants have been left, at most, with what some describe as a "passive de-snugging"--that is, a willingness of the Fed to see funds rates slip a bit under what

had been the prevalent 6-3/4 percent level. Meantime, market participants seem impressed with more fundamental factors such as continuing evidence of economic growth and potential for inflationary pressure as the trade deficit narrows in real terms and labor markets tighten. The failure to come to grips with additional budget deficit reduction measures is also a sobering factor. Few market participants seem inclined to make much of the recent slow money growth, given their view of an over-all satisfactory pace of real economic growth with some likelihood of re-emergent price pressures.

Request for Additional Leeway

Current projections indicate a high likelihood that the normal \$6 billion leeway for changes in outright System holdings will not be sufficient between now and the next Committee meeting scheduled for September 22. The main factor draining reserves is expected to be a large build-up in Treasury cash balances after the mid-September tax date. Another debt ceiling crunch at around that time could affect the problem as it unfolds but most likely will still leave a need for greater leeway. My recommendation is to increase the usual leeway to \$10 billion though it should be noted that tax payment estimates can go awry and we could end up needing even more. However, it would be hard, this far in advance, to pinpoint a more refined number with any confidence.

FOMC Briefing -- The Economic Outlook

The staff forecast has not changed much from that presented at the July meeting. The overall picture remains one of moderate growth in real GNP through the end of next year, with domestic demand likely being damped by somewhat higher interest rates. Wages accelerate noticeably, but price inflation is only a little bit faster in 1988 than in 1987.

Looking closely at our projection, we have nudged up very slightly -- a tenth of a percent or two -- both real growth and price inflation over the next six quarters. The economy seems at this point to have a bit more upward momentum than we had previously anticipated. Before the Greenbook was sent to the presses, the key evidence on that score was the labor market report for July. The report showed a sizable 300,000 gain in payroll employment, which included 70,000 additional jobs in manufacturing. The jump in factory payrolls was all the more striking because it came even as auto industry employment fell almost 40,000, owing to the influence of inventory reduction efforts and model changeovers. Moreover, the household survey indicated a 470,000 increase in employment and a surprising further decline in the jobless rate, to 6 percent.

The payroll data, along with available physical product measures, pointed to a strong increase in industrial production in July. The data we published last Friday revealed not only an 0.8 percent jump in IP in July, but also upward revisions in prior months. The more impressive uptrend in industrial activity

squares nicely with the run-up in materials prices this year, as well as with a tendency toward trade-driven growth.

Developments prior to the Greenbook also suggested that we might see stronger consumer spending than we had previously projected. For the near term, the announcement of more generous incentives by the domestic car makers indicated the likelihood of a bunching of consumer outlays in the third quarter. For the longer haul, our thinking was influenced by the upward revisions in the personal income and saving data for the past year or so, and by the continuing surge in the stock market.

The data received late last week were consistent with the thrust of our analysis. Domestically produced autos sold at an 8.2 to 8.9 million annual rate in the first ten days of August, depending on whose seasonal factors you employ; the enhanced incentives were in place for only part of the period, and if this pace is maintained, enough cars will be sold to eliminate the overhang of dealer stocks by the end of the quarter, given low assembly schedules. The July retail sales data also were favorable; indeed, the key nonauto components were, in combination with upward revisions for the preceding months, a bit stronger than we had been looking for.

Incoming information on business spending also has been upbeat, on balance. The June figures on shipments and orders, coupled with our expectation of good car and truck sales, have led us to revise upward slightly our forecast of third-quarter spending on equipment. Meanwhile, the downslide in outlays for

nonresidential structures appears to have abated, with rising oil drilling activity and strong demand for private educational buildings offsetting weakness in commercial construction.

On the inventory side, the figures through June suggest that manufacturers' stocks are quite lean. Given the trends in orders, we would expect to see some effort to build inventories in the period ahead. At trade establishments, the picture is less consistent, but, outside of autos, there seem to be no major imbalances; the apparent upturn in retail sales of apparel and furniture in the past couple of months is reassuring in this regard.

In the housing market, the evidence at Greenbook time pointed to the leveling off we had expected in activity in June. This morning we received July housing starts, which were right on target with our forecast at a 1.61 million unit annual rate -- the same pace as in May and June.

Last Friday, as you know, the merchandise trade figures for June came out, and the deficit for the month was much larger than the market expected. It was also somewhat larger than the staff had anticipated. Nonetheless, our estimate of what these numbers will look like when they are converted to a balance of payments basis, which relates more directly to the GNP data, indicates that the trade deficit will be little changed between the first and second quarters. Since we were not looking for anything other than sideways movement in the nominal trade balance until next year, these data would not cause us to revamp our basic view of

the likely contribution of net exports to real GNP over the forecast period. I perhaps should note parenthetically that real net exports are expected to decline slightly in the third quarter, owing to the surge in oil imports associated with precautionary stockbuilding. I should also note that oil inventories are notoriously elusive in the GNP data, and if they don't show up on this occasion, GNP could be understated in the current period.

The trade numbers, and the market reaction to them, did tend to underscore what we have regarded as a key inflationary risk in our forecast -- namely, the possibility that the dollar may have to depreciate substantially further to produce an acceptable improvement in our external position.

The recent wage and price indicators have presented a mixed picture. Abstracting from food and energy price swings, the latest readings on producer prices for finished goods and consumer prices for goods and services suggested relatively moderate inflation. Moreover, recent wage and compensation data gave no indication that labor costs, on the whole, had begun to accelerate. Prices of nonpetroleum imports did post another appreciable increase between March and June, however; and the prices of domestically produced industrial materials and intermediate components and supplies have been climbing noticeably, evidently reflecting reduced pressure from foreign competition and stronger demand in several industries, as well as the pass-through of higher costs for petroleum-based products.

It remains our expectation that prices of final goods and services will decelerate a bit in the second half of the year. But this slowing is almost entirely attributable to smaller increases in food and energy prices. The former seems to be in train, with the July PPI showing a drop in meat, fruit and vegetable prices, and the latter of course depends on the continued availability of oil from the Persian Gulf region. To date, OPEC production apparently has run above quota, damping the rise in oil prices; we have assumed that, when precautionary demands ebb, output will recede, and the price will remain around the OPEC target of \$18 per barrel. While the possibility exists that prices will overshoot on the downside, it also is clear that the oil market constitutes an area of potentially significant upside inflationary risk in the forecast.

Looking beyond the second half, we continue to project a reacceleration of inflation, with the fixed-weight price index for GNP rising almost 4-1/2 percent over the four quarters of 1988, compared with 4 percent on average this year. I perhaps should note that the inflation rates for both years have been raised a bit in light of the Commerce Department's GNP revisions, which revealed, among other things, stronger uptrends in government spending deflators. The basic story has remained the same, however: we expect that the competing goods effect from rising import prices, in combination with accelerating labor costs, will put more upward pressure on the prices of domestic production.

In addition, prices likely will be getting a small boost from rising federal and state and local excise taxes.

With regard to labor costs, we continue to show compensation increases moving from the recent 3 to 3-1/2 percent range up to about 4-3/4 percent by the second half of 1988. We have not tacked on a minimum wage hike, which of course constitutes another risk in the outlook. But the greater risk, in our minds, is posed by the downtrend over the past several months in the unemployment rate. The drop in the jobless rate has been considerably more than would be explained by the reported increase in real GNP, according to the so-called Okun's law formulation. The disparity may have several explanations: GNP growth may actually have been stronger than we now think; or we may have reached a point where labor force participation rates are leveling off; or average productivity could be deteriorating, perhaps because we are running out of high quality labor; or the drop in unemployment may simply have been overstated.

The fact is that we don't really know, and we may not know for some time. We think there is a distinct possibility that the unemployment rate will bounce up in the next few months, and we have put a small uptick in our forecast. More fundamentally, the notion underlying our projection of wages is that, whether the true jobless figure is 6 percent or a little higher than that, we basically are now and will be in a zone where general labor market slack is no longer a source of downward pressure on real wages. We can't rule out the possibility, though, that the

seemingly moderate output growth we've forecast will push unemployment significantly lower and put enough pressure on labor resources that wages will accelerate more than we have forecast.

In the end, we believe our forecast continues to describe the most probable outcome for output and prices over the next year or so. However, I must say that we also have an uneasy feeling that recent developments may be signalling an increased risk that inflationary pressures will be greater than we have been anticipating.

Mr. Chairman, I have spoken too long already, so let me just note that we have distributed to the Committee a summary of the Administration's revised economic and budget forecast, issued yesterday in the midsession review document. The CBO's updated projections are due out tomorrow, and will show an economic forecast closer to our own and an FY88 baseline deficit also closer to ours. The \$25 billion of deficit-reduction action we've assumed is less than the congressional budget resolution or the Administration numbers call for, but given the record, this is one forecasting risk we are fairly comfortable taking.

FOMC Briefing
Donald L. Kohn
August 18, 1987

In some respects the Committee faces what has become a familiar situation in interpreting incoming financial and other data as background for its decision today. Growth of the broad monetary aggregates remains sluggish relative to their annual ranges, but other indications in financial markets and the economy do not suggest that the thrust of policy has been especially restrictive.

Growth of the monetary aggregates picked up in July, and recent data suggest that a further acceleration is in train this month. The blue-book paths encompass growth in the aggregates roughly in line with the expected trend of income over coming months, as the effects of earlier increases in interest rates and the opportunity costs of holding deposits abate.

The acceleration is anticipated to be especially marked for M3, which was depressed by unusually weak bank credit growth in July. This aggregate would be expected to remain under the lower end of its long-run range through September, but to climb within that range during the fourth quarter, given the staff's projection of a moderate pace of credit expansion at depository institutions and reasonably normal funding patterns for that credit.

M2, however, is sufficiently below its range that the faster growth rates envisioned would still leave it well short of the Committee's long-run target range in September, and raise serious questions about the attainability of that range for the year. Under the unchanged reserve conditions assumed for alternative B, M2 is projected to grow at a 5 percent rate over June to September, which would require expansion at about a 11-1/2 percent pace in the last three months of the year to hit the lower

end of the range in the fourth quarter. Even under alternative A, whose easier reserve conditions should have a considerable impact on money growth in the fourth quarter, attainment of the M2 range would be uncertain.

The Committee has stated that M2 growth below its range could be acceptable, depending on the circumstances. Looking at it from the perspective of the demand for money, the principal reason for the weak growth this year and associated rise in velocity, just as it was for the strong growth and velocity declines in 1986, seems to have been market interest rate movements and changes in opportunity costs given the lagging response of deposit rates, especially on the liquid money assets.

But growth of M2 has been weaker than might have been expected from interest rate effects alone, at least based on historical relationships embodied in our money demand equations. To an extent, this result may be an aspect of the apparent moderation in overall growth of household financial assets (abstracting from stock market wealth) that seems to have developed this year, perhaps as a counterpart to reduced debt accumulation under the new tax laws. In addition, demand deposits have been unusually weak, possibly reflecting greater interest sensitivity than evident earlier as compensating balances come to more nearly dominate holdings. This may well show through into M2, since demand deposit weakness is less likely to involve shifting into other M2 assets than is weakness in OCD. In its projections, the staff has allowed for some ongoing shortfall in M1 and M2 growth relative to model results, but not as much as has been evident earlier this year, with our courage bolstered by the more robust pattern that seemed to be developing over late July and early August.

Viewed from a broad economic perspective, relatively slow money growth this year may be considered appropriate in circumstances of higher inflation and inflation expectations, and stimulus to the economy from an improvement in the external sector. Reflecting this situation, other indicators of the thrust of monetary policy do not appear to suggest that the deceleration in money growth thus far will result in a weaker economy than might be consistent with progress towards the long-run goals of price stability, growth, and international balance--and some signals suggest that, if anything, forces--or at least fears--of inflation are still very much in evidence, despite the behavior of money.

For example, the rise in nominal interest rates, which has played such a key role in the money story, has accompanied a pickup in inflation expectations and therefore does not seem to signal a comparable rise in real rates. Measured from last fall, one year ahead projections of inflation--in the greenbook, by outside forecasters, and by survey respondents--have increased up to 1 percentage point, just short of the rise in one-year Treasury bill rates over the period, implying only a small increase in real interest rates. Using these various alternative measures of inflation expectations, this one-year real rate is estimated at around 2-1/2 percent, not unusually high by historic standards. In circumstances in which a major boost to economic growth is expected to arise from a continued improvement in external imbalances, a somewhat higher real interest rate may be needed to restrain domestic demand--especially in the absence of definite prospects for continued progress in reducing federal government budget deficits. Certainly, the behavior of the stock market this year does not suggest that investors view monetary policy as having been unduly restrictive; and the backup in bond yields in the United States

and elsewhere around the world recently seems to indicate a sensitivity in financial markets to the possibility that the effects of rising prices are more likely to dominate credit markets over the years ahead than is the impact of any weakness in economic growth. This is reflected in the domestic yield curve as well, which remains upward sloping, and is steeper than last fall when many expected that weakness in the economy in 1987 would necessitate an easing of policy this year.

Other sensitive indicators have shown mixed signals over the past few months, but when viewed relative to late last year also seem to indicate that policy has not been a particularly restrictive force. Commodity prices have been relatively flat in recent weeks, but are well above levels of last fall. And while the exchange rate has risen on balance since late May, in terms of other G-10 currencies, it remains about 6 percent below its level of last November.

As Mike noted, the staff forecast embodies a view that demands on the U.S. economy will be reasonably strong, and the margin of unused resources in the economy is sufficiently narrow that a further rise in nominal interest rates and restrained money growth will be needed to keep inflation from accelerating substantially, especially given the boost to prices in the forecast from a further dollar decline. Concern about an outlook along these lines might argue for a near-term tightening of reserve conditions, as under alternative C, or a tilt in the directive so that the Account Manager would be particularly sensitive to the need to tighten should additional information point toward strengthening price pressures. Such a tilt would be consistent with a view that current conditions

might not yet warrant a tightening, but that the risks of damping the economy unduly by moving to that side in response to incoming information are far less at this point than the risks of spurring additional inflation by moving to an easier stance, without very strong evidence that a satisfactory path for the economy required such an easing.

An alternative view might stress the weakness of the aggregates, various downside risks to the economic outlook and the implications for the price picture of continuing moderate behavior of labor costs. It is difficult to dismiss the aggregates altogether--their growth last year, along with the dollar's depreciation was one of the few indicators we had that monetary policy was reasonably expansive and that the economy in 1987 might be stronger than the consensus view. If the slower money growth were contributing to the firmer dollar, this might have important implications for the outlook. A dollar that remained strong along with sluggish activity abroad would tend to produce both weaker prices and domestic economic growth than in the staff forecast. Such a view would be consistent with at least a balanced directive under unchanged reserve conditions, on the grounds that the odds on a more restrained outcome should not be downplayed without additional evidence of strength in prices or the economy. In particular, if the aggregates were considered to have some informational content, further shortfalls in M2 might even weigh towards reducing reserve pressures. And, if the downside risks were thought to be particularly strong, this view might imply a tilt toward ease or even choice of alternative A.

In any case, Mr. Chairman, the staff has included the usual array of "mights" and "woulds" in the draft directive that could be used to indicate more of a readiness to move toward ease or tightening. The draft

directive also contains some wording suggestions should the Committee wish to change the emphasis on various factors conditioning intermeeting adjustments. In particular, the Committee may want to consider whether the dollar should have the same prominence it now has, which evolved through the period of severe downward pressure on the dollar. Finally, in view of the weakness in the aggregates, the staff has supplied language that would indicate that faster growth than the Committee's short-run specifications would be acceptable, provided there were no evidence of troubles on the inflation or dollar fronts; this would allow for the possibility that should some of the earlier weakness begin to be reversed, the desk would not necessarily weigh that heavily on the side of seeking firmer reserve conditions.